

Commentary
on Pertinent
Economic
Issues

Irwin L. Kellner
Chief Economist

Manufacturers
Hanover
Economics
Department
17/270

Time To Ease

Nearly a quarter of a century ago, it was becoming increasingly obvious that, after years of battling the communists, the United States was slowly sinking into the quagmire of Vietnam. As the search for a face-saving way of extracting ourselves from this situation intensified, Senator George Aiken (R-Vt) came up with an interesting idea, which, if used at that time, might well have saved many lives—not to mention millions of dollars. In a speech on the Senate floor in October 1966, he said that we "...could well declare unilaterally that this stage of the Vietnam War is over—that we have 'won' in the sense that our armed forces are in control..." In other words—we should declare that we won the war and go home.

Today a similar situation has developed which seems to call for a similar declaration. For after years of the Federal Reserve's battling inflation, it now appears that the U.S. economy is in danger of sinking into recession. Indeed, some economists—and quite a few businessmen and consumers—would put it even more bluntly. They point out that, with about half the economy—measured either geographically or by product line—already declining, the threat of a national recession is now the greatest in almost eight years.

The Fed has been keeping its credit reins fairly snug because of what it believes is an ongoing inflation threat. Yet most of the inflation consumers are confronted with today appears to be in services over which the Fed has little control; prices of many goods have either stopped rising, or, in some cases, are even falling. Thus it would seem that Senator Aiken's suggestion of 24 years ago might be applicable to Alan Greenspan and his colleagues at the Fed: Declare victory over inflation, loosen the credit reins and let interest rates decline.

To be sure, Mr. Greenspan acknowledged last month before several Congressional forums that the Fed has eased its monetary policy. But he pointed out that such a move—which has already shown up in a slight decline in the Federal funds rate—was in response to signs that

banks and other lenders were becoming so cautious as to create "crunch"-like conditions for certain types of borrowers in certain areas of the country. The Fed chairman added that he did not believe major easing was necessary at the moment, insisting that he didn't think the economy was all that weak.

From here, it would appear that the evidence suggests otherwise. For one thing, fiscal policy may be on the verge of tightening, as the President and leaders of Congress seriously examine ways to reduce Washington's budget deficit (Economic Report—June 1990). And no matter how the gap is closed—either through spending cuts, tax increases, or both, any significant reduction represents fiscal restraint, for it drains spending power from consumers and business. Since the economy has virtually slowed to a crawl, this tightening is the last thing that's needed—especially in light of the belt-tightening at the state and local levels—unless it is offset by easier money and lower interest rates.

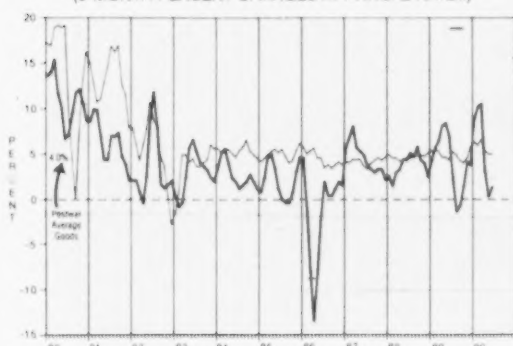
Goods Are Down

Fiscal policy aside, it would seem that easier money is called for because the Fed has won the war against the portion of inflation it is capable of beating—prices of goods. What's more, it has done so by knocking the goods sector—which accounts for more than half of our gross national product—flat on its back. Goods' prices at the consumer level fell in April and again in May, seasonally adjusted, before rising in June. However, on a three-month basis, goods' prices are up only 1.3 percent, compared with the postwar average of four percent—and a three-month jump of 10½ percent earlier this year (Chart I)!

Going back one step in the production process, the Labor Department's producer price index for finished goods is up little more than three percent over the past 12 months; at the beginning of this year, this index's 12-month rise was nearly twice as much. Prices of intermediate goods, a further step back in the production process, have risen only 0.3 percent in the past 12 months compared with 2½ percent six months ago. And at the earliest stage, raw materials, prices are down a hefty three percent over the past year; they were five percent

higher, year-over-year, back in January—and nearly nine percent above their year-before levels last November.

CHART I
CONSUMER PRICE INDEX: GOODS (THICK) VS. SERVICES (THIN)
(3-MONTH PERCENT CHANGES AT ANNUAL RATES)



Source: Bureau of Labor Statistics

It's not too difficult to find out why. Goods sales are falling. Before rising slightly in June, retail sales had declined three months in a row—the first time that has happened since the last recession. Second-quarter GNP data reveal that personal spending on goods—one-third of GNP—fell from year-earlier levels. Only twice in the past 45 years has such a full-year drop *not* led to a recession (Chart II). Although most of these declines are in the durable goods sector—mainly sellers of building materials, hardware, garden supplies, mobile home and automotive dealers—quite a few retailers of softgoods are feeling the pinch as well. For example, sales at department stores, apparel specialty outlets, food stores and gasoline service stations are up—but not as much as inflation, according to the Commerce Department.

Not surprisingly, goods payrolls are down. In the past three months over 200,000 people engaged in the production of goods have lost their jobs. With one exception—the three months ending in May of this year—this is the biggest decline for any three-month period since the last recession. Indeed, *all* payrolls would have stopped growing in the past three months, were it not for the decennial hiring of census takers by Washington. To prove the point, the number of nonfarm industries adding to payrolls in June was the smallest in more than 7½ years.

Once again, the goods side is taking the biggest hit. Employment in both durable and non-durable goods industries is down over the past

12 months with most of the Labor Department's major categories coming up negative. As a matter of fact, only three industries—publishing, chemicals and petroleum—added to their payrolls over the past 12 months. Service industries are doing better, although not as good as last autumn, once you factor out the government. One reason is the financial sector. While the banks are still expanding their workforces, they are doing so at a decidedly slower pace than last year—while Wall Street continues to shed employees.

One of the hardest hit areas is construction. In the past 12 months, only 9,000 people found work in this industry; as recently as this past February, the 12-month rise was a healthy 215,000. In view of how sick residential construction is, it would not be surprising if payrolls in this sector were to start shrinking, year-over-year. New-home construction has fallen five months in a row and is currently running at the lowest pace since the last recession. Nonresidential construction isn't doing much better; business real outlays for structures such as factories, office buildings, warehouses and the like at midyear were about the same as they were at the end of 1973—16½ years ago!

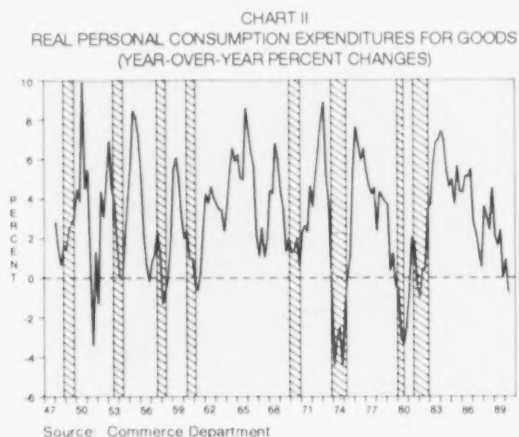
People aren't buying new homes for a number of reasons, but the main one is they can't afford them. Today, the average home costs more than four times the average family's income, compared with less than 2½ times 20 years ago, when residential construction was at its peak. And this comparison includes the fact that the average family 20 years ago had one breadwinner, whereas today it's usually at least two people holding down three (or more) jobs. For its part, business spending on structures is being constrained by the low rate of capacity use, and by sluggish profits.

Even export growth, the bright spot in the U.S. economy, is beginning to dim. After logging in year-over-year gains of as much as 30 percent in early 1988, export growth has since throttled back to little more than eight percent. As a partial consequence, factory output's annual growth has slowed concurrently, from nearly eight percent 2½ years ago, to about a sixth as much today.

Services Are Up

When you look at the service sector, however, a different picture emerges, as though the U.S.

economy had a split personality. For service prices are still climbing at an annual rate of $5\frac{1}{2}$ percent. This is essentially the same pace they've been clocked at since the beginning of the current expansion nearly eight years ago. It is nothing short of amazing, considering the ups and downs to which the economy has been subject during this time. It is, however, not all that surprising, once you inspect this sector more closely.



For one thing, services tend to be labor intensive. That is to say they require about as much labor per output as they ever have. Several examples would be doctors, lawyers, beauticians, accountants, musicians and teachers. Thus when the cost of these people's efforts rises—and it's been climbing around five percent per year—it's hard for them or their employers to avoid raising prices. These price hikes tend to stick because, unlike many goods, services tend to be necessities, leaving consumers with little or no choice, when it comes to paying the tab.

Take medical care and education. For nearly 30 years, medical services have been rising twice as fast as the overall consumer price index. In the past dozen years, the cost of education has ratcheted up 50 percent faster than the CPI. And let's not forget local governments which add to service inflation when they boost transit fares, tolls on highways, bridges and tunnels, and, of course, taxes. There's no way that the Federal Reserve can prevent these kinds of price hikes—unless it were to become so tight that the current weakness in the goods sector

would spread to services, pulling the entire economy into a long and deep recession.

The Fed's Still Tight

Not that the Fed isn't tight already. The recent dip in the Federal funds rate notwithstanding, total bank reserves, the raw material that banks use to make loans and investments, have expanded by only 1.2 percent over the past three years. This is plainly the slowest 36-month rise since the three years ended February 1958 (when the economy was in a recession), and compares with an average 36-month rise of 15 percent over the past 43 years. As a result, the broadest measure of the money supply, M3, is currently growing at its slowest 12-month pace in at least 20 years. This is the major reason why real interest rates (rates adjusted for inflation) remain well above their postwar averages.

These high interest rates are exacerbating another problem faced by consumers, business and governments the world over—huge debt loads. Consumer debts have never been higher, when compared with their incomes, thus their ability to repay. For its part, business in the aggregate must now set aside nearly half its net cash flow just to service its debt. Five years ago, this ratio was only 25 percent.

The jump, of course, reflects the combination of rising debt and falling profits. Earnings are down because companies aren't selling enough to cover their costs, and because they can't raise prices, either. As a consequence, profit margins have fallen almost continuously since 1985, and now stand at their lowest point since the last recession—little more than half their postwar average. Unless this improves, dividend payouts, now historically high relative to net profits, will have to be cut. Considering that price-earnings ratios are already a third above average and interest rates are high enough to be pulling money into bonds, any widespread cuts in dividends would seem to put stocks at risk of a substantial decline.

When Alan Greenspan was President Ford's chief economic adviser, he started a campaign to Whip Inflation Now, and handed out WIN buttons. Maybe it's time for the Fed to move from WIN to LOSE (Lift Our Sluggish Economy) so we can have a DRAW (Deliberate Recovery At Work).



Global

**With Customers In Over 100 Countries,
We Speak A Universal Language.**



The language that moves the world's portfolios. With speed. With ease. With custodial expertise that's not just talk.

It's technology. Our unsurpassed securities workstation — GEOPAC™. An electronic messenger that delivers all the information you need to manage your investments. Real time. On line. Just press the key.

It's presence. A network of subcustodians with the local clout to process your orders smoothly, successfully. A persuasive voice heard all across the globe.

It's commitment. An organization settling a single transaction every other second and over 10,000 every single day. Faster than you can say GEOSERVE.

When you talk — we listen. In your language. Let us hear from you. In New York, call Diane Reyes, Vice President at (212) 270-4694 or in London, John Gibson, Vice President at (01) 932-3609.

**GEOSERVE™
We Get Around**

©1990 Manufacturers Hanover Trust Company
All Rights Reserved. Member FDIC. Member of the Securities Association.



Manufacturers Hanover Corporation
Bank Window, Church St. Station
New York, N.Y. 10015

Bulk Rate
U.S. Postage
PAID
Manufacturers
Hanover

00463000024182 C 923 CONGRO001
CONGRESSIONAL INFO SERVICE
ATTN: SRI
4520 EAST-WEST HWY
BETESDA, MD 20814

**Economic
Report**